

Message Text

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AMEMBASSY SEOUL

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USLO PEKING

C O N F I D E N T I A L SECTION 1 OF 2 HONG KONG 11231

PASS TREASURY AND FEDERAL RESERVE BANK

E.O. 71652: GEY

TAGS: HK, EFIN

SUBJ: HONG KONG: GRADUAL STABLIZATION AND STAGNATION

1. INTRODUCTION. IN THE SHORT-RUN HONG KONG FACES STAGNATION AS THE WORLD RECESSION REACHES IT. OVER THE LONGER-TERM IT HAS HAS PROBLEMS OF FINDING NEW SOURCES OF REVENUE TO FINANCE GROWING GOVERNMENT INVESTMENT AND OF FACING STIFFER COMPETITION FROM ITS NEIGHBORS IN COMMON EXPORT MARKETS. THIS CABLE ADDRESSES MAINLY CURRENT ISSUES BUT SUGGESTS THAT HONG KONG'S LONGER-TERM POLICIES ARE PART OF ITS PROBLEMS.

2. SUMMARY. THE PRINCIPAL CONCLUSIONS ARE:

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A) PRICES ARE GRADUALLY STABLIZING AFTER REACHING UNPRECEDENT

RATES OF INCREASE IN 1973, B) GDP, IN 1974, MAY RISE TWO PERCENT, IN REAL TERMS, FOLLOWING A GROWTH OF 8-9 PERCENT LAST YEAR AND, C) HONG KONG'S ENORMOUS DEPENDENCE ON EXPORTS AND DIMINISHED COMPETITIVE POSITION MAKES IT ESPECIALLY VULNERABLE TO THE CURRENT RECESSION IN ITS MAJOR FOREIGN MARKETS, AND D) THEREFORE, AN UPTURN IN GROWTH IS UNLIKELY BEFORE THE SUMMER OF 1975.

3. INFLATION & MONETARY POLICY. INFLATION, AS IN OTHER COUNTRIES IN THE PAST TWO YEARS, WAS PARTLY IMPORTED AND PARTLY GENERATED DOMESTICALLY. EXTERNALLY, THE MAIN PROBLEM WAS THE INCREASE IN THE COST OF IMPORTED FOODSTUFFS BEGINNING EARLY IN 1973, PARTICULARLY RICE. BUT MONEY SUPPLY TRENDS INDICATE THAT THE INTERNAL BOOM AND ESPECIALLY THE LIQUIDITY ARISING FROM STOCK MARKET SPECULATION WAS A MAJOR FACTOR. THE TABLE BELOW INDICATES HOW THE RATE OF GROWTH OF MONEY AND PRICES HAVE CHANGED IN THE PAST TWO YEARS.

DATE	CONSUMER BANK		MONEY SUPPLY	
	PRICES	CREDIT	(M1)	(M3)
	(ANNUAL INCREASE IN PERCENT)			
12/72	9	50	44	29
12/73	19	21	4	7
4/74	20	29	-6	13
7/74	14	28	--	15
8/74	6	23	-4	14

4. RAPID MONEY SURPLUS AND CREDIT GROWTH IN 1972 PRECEDED THE TAKE-OFF OF PRICES IN 1973. THE OUTFLOW OF CAPITAL IN THE SECOND AND THIRD QUARTERS OF 1973, AFTER THE COLLAPSE OF THE STOCK MARKET, LED TO A MORE CAUTIOUS BANK LENDING POLICY. TIGHTER CREDIT UNTIL THE SECOND QUARTER OF 1974, AND THE PEAKING OF GRAIN PRICES ON THE WORLD MARKET LAST SPRING, SEEMS TO BE GRADUALLY SLOWING PRICE INCREASES.

5. IN RECENT MONTHS (Q TO AUGUST), THE BANKS ARE LENDING SOMEWHAT MORE FREELY BASED ON A NEW INFLOW OF CAPITAL FROM ABROAD. THE ANNOUNCEMENT BY THE HONG KONG AND SHANGHAI BANK, AT THE BEGINNING OF MAY, THAT THE HANG SENG STOCK PRICE INDEX OF 300 SHOULD BE CONFIDENTIAL

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CONSIDERED A FLOOR, AND THAT, THE BANK WAS ONCE AGAIN PREPARED TO LEND ON SECURITIES COLLATERAL, SHOULD BE REGARDED AS A SEMI-OFFICIAL SIGNAL THAT THE AUTHORITIES DID NOT WISH TO SEE A FURTHER DECLINE IN ACTIVITY. UNFORTUNATELY FOR THIS OBJECTIVE, THE RISE OF INTEREST RATES IN NEW YORK AND LONDON, BY MOMENTARILY SUCKING MONEY OUT OF HONG KONG IN JUNE AND JULY, FORCED UP THE LOCAL PRIME RATE IN JULY TO 12 PERCENT COMPARED TO 9 3/4 PERCENT ESTABLISHED LAST SEPTEMBER, AND TIME DEPOSITS YIELDS FROM 8 PERCENT

TO 10 1/4 PERCENT. ON BALANCE, HOWEVER, THE LIQUIDITY SITUATION IS EASIER NOW THAN IN THE PERIOD JUNE 1973 TO MARCH 1974. THIS VIEW IS ALSO SUPPORTED BY THE INCREASE OF TIME DEPOSITS, (THE MAIN DIFFERENCE BETWEEN THE M1 AND M3 COLUMNS), AN INDICATION OF RISING BUSINESS LIQUIDITY.

6. INTERNATIONAL TRADE. HONG KONG'S MAJOR PROBLEM IS THE FALL OFF OF DEMAND FOR ITS PRODUCTS OVERSEAS. THE MAIN TRENDS IN FOREIGN TRADE IN THE FIRST HALF OF 1974 ARE:

- A) A MARKED SLOWDOWN IN EXPORTS (IN CONSTANT PRICES) FROM AN 8 PERCENT RATE OF GROWTH IN 1973 TO 7 PERCENT THIS YEAR,
- B) A FALL IN THE TERMS OF TRADE OF APPROXIMATELY 5 PERCENT,
- C) A THREE PERCENT DECLINE IN RAW MATERIAL AND SEMIMANUFACTURED IMPORTS.

ALL OF HONG KONG'S MAJOR MARKETS - THE U.S., U.K N AND GERMANY, SHOW A DECLINE IN VOLUME TERMS. IT WAS ONLY THE ENLARGEMENT OF MARKETS IN AUSTRALIA, NEW ZEALAND AND A FEW OTHERS THAT HAVE MAINTAINED SOME GROWTH. ALTHOUGH THE COLONY HAS PUSHED UP ITS EXPORT PRICES 35 PERCENT IN THE PAST YEAR, THE CONTINUED RISE OF FOOD PRICES AND THE NEW LEVEL OF OIL PRICES HAVE PUSHED UP IMPORT PRICES EVEN FASTER. TO ILLUSTRATE: THE LANDED PRICE OF OIL PRODUCTS INCREASED 2.8 TIMES IN THE SECOND QUARTER COMPARED TO A YEAR AGO WHILE VOLUME ROSE 7 PERCENT. FINALLY, THE REDUCTION IN RAW MATERIAL IMPORTS IS USUALLY AN INDICATION OF SLOWING EXPORT ORDERS AND GROWTH.

7. US-HK TRADE. THE EFFECTS OF THE EXCHANGE RATE APPRECIATION OF THE HK DOLLAR VIS-VS THE U.S. DOLLAR THAT TOOK PLACE IN LATE 1971 AND EARLY 1973 CONTINUES TO BE FELT. HK EXPORTS TO THE UJXS. FELL 3 PERCENT IN VOLUME TERMS IN THE FIRST HALF OF 1974 AS COMPARED TO SAME PERIODSMF 1973 WHILE IMPORTS FROM THE U.S./ 49 3 21 PERCENT. THE U.S. SHARE OF THE DOMESTIC MARKET (EX-
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CLUDING REEXPORTS) HAS INCREASED FROM ABOUT THE 12 PERCENT RULGE TO 14 PERCENT WHILE THE HONG KONG SHARE OF U.S. IMPORTS HAS FALLEN FROM 2.1 PERCENT TO 1.6 PERCENT. BUT, THE INTIAL TRADE SURPLUS IN FAVOR OF HK WAS SO LARGE THAT IT IS ONLY DECLINING AT THE RATE OF U.S. \$50 MILLION A YEAR.

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8. BALANCE-OF-PAYMENT POSITION. AS USUAL IN HONG KONG, THE LACK OF INFORMATION, EXCPT ON VISIBLE TRADE, OBSCURES THE BALANCE-OF-PAYMENTS POSITION. WHAT IS CLEAR IS THAT:

A) THE TRADE DEFICIT IS AT ANNUAL RATE OF \$900 MILLION THIS YEAR COMPARED TO \$600MILLION IN 1973,

B) THERE HAS BEEN AN INFLOW OF FUNDS THROUGH THE BANKING SYSTEM OF ABOUT \$200 MILLION IN THE FIRST EIGHT MONTHS, AND

C) OFFICIAL RESERVES HAVE VARIED VERY LITTLE,

D) THE INVISIBLES ACCOUNT HAS PROBABLY DETERIORATED GIVEN THHE SLOWER GROWTH OF TOURISM.

IN THE FREE EXCHANGE MARKET, WITH APPARENTLY NO GOVERNMENT INTER-CONFIDENTIAL

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VENTION, THE EXCHANGE RATE HAS REMAINED VERY STEADY USUALLY AT LEVELS SLIGHTLY BETTER THAN PARITY (5.085/1). THE TREND OF THE TRADE-WEIGHTED EXCHANGE RATE HAS BEEN FLAT SINCE JANUARY. IT, THEREFORE, WOULD APPEAR THAT THE OVERALL BALANCE-OF-PAYMENTS

IS IN EQUILIBRIUM OR SMALL SURPLUS WHICH PROBABLY MEANS THAT A LARGER PROPORTION OF IMPORTS ARE BEING FINANCED BY FOREIGN CREDITS THIS YEAR THAN LAST.

9. EXCHANGE RESERVES. OFFICIAL RESERVES ARE ESTIMATED TO BE \$1.1 BILLION DOLLARS, AS OF JUNE 30, WHILE THE COMMERCIAL BANKING SYSTEM HELD \$2.4 BILLION OF FOREIGN ASSETS AS OF THAT DATE. THIS STOCK, WHEN COMPARED WITH A CURRENT ANNUAL LEVEL OF RETAINED IMPORTS (IMPORTS-REEXPORTS) OF U.S. \$5.5 BILLION, YIELDS THE VERY COMFORTABLE RESERVE RATIO OF EIGHT MONTHS OF IMPORTS.

10. THE FISCAL SITUATION. HONG KONG HAS HAD, TRADITIONALLY, LOW TAX RATES AND A LARGE BUDGET SURPLUS. IN THE 1973-74 FISCAL YEAR (ENDING 3/31/74) THE SURPLUS DROPPED TO HK \$70 MILLION COMPARED TO HK \$635 MILLION THE YEAR BEFORE. REVENUE COLLECTIONS, WHICH HAD RISEN RAPIDLY YEAR AFTER YEAR, SLOWED DOWN WHILE EXPENDITURE CONTINUED TO MOVE AHEAD. GIVEN THE MAJOR INVESTMENT PROGRAMS BEING UNDERTAKEN BY THE HONG KONG GOVERNMENT, THE PROJECTION OF EXPENDITURES AND REVENUE AT THE PRESENT RATES SUGGEST THAT A DEFICIT WILL DEVELOP PROBABLY THIS FISCAL YEAR AND BECOME LARGER IN THE FOLLOWING ONE. THE FINANCIAL SECRETARY HAS WARNED THAT A TAX INCREASE MAY BE NECESSARY. WITH A TOP COMPANY AND INDIVIDUAL INCOME TAX RATE OF 15 PERCENT, THERE IS A CONSIDERABLE MARGIN TO RAISE RATES WITHOUT SERIOUSLY EFFECTING BUSINESS. A PROLONGED DEFICIT WILL ALMOST SURELY BE AVOIDED BUT THE NEW FISCAL OUTLOOK DOES MEAN THAT:

A) THE HISTORIC STABILIZING EFFECT OF THE BUDGETARY SURPLUS ON THE PRICE LEVEL IN THE FUTURE WILL DISAPPEAR AND,
B) THE ACCUMULATION OF OFFICIAL FOREIGN EXCHANGE RESERVES (A LARGE PART OF THE BUDGET SURPLUS IS INVESTED IN THIS FORM) WILL BE SUBSTANTIALLY SMALLER IN THE FUTURE.

1. THE OUTLOOK. THE CURRENT ATMOSPHERE IS GLOOMY. THE HANG SENG STOCK PRICE INDEX HAS RETURNED TO THE LEVEL OF 1971 (200). THE VOLUME OF NEW FOREIGN ORDERS IS DISAPPOINTINGLY SMALL AND THE RATE OF

GROWTH OF EXPORTS WILL ALMOST CERTAINLY FALL OFF, PERHAPS TO ZERO IN THE SECOND HALF. THE OFFICIAL 4 PERCENT ESTIMATE OF GDP
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GROWTH FOR 1974 IS NO LONGER ACCEPTED (PRIVATELY) EVEN BY THE ALWAYS OPTIMISTIC HKG. TWO PERCENT IS MORE LIKELY WHICH AGAIN IMPLIES NO GROWTH IN THE SECOND HALF. WITH NO EVIDENCE YET OF A SIGNIFICANT UPTURN OF ACTIVITY IN THE U.S., U.K., OR GERMANY, HONG KONG'S MAJOR EXPORT MARKETS, RESUMPTION OF GROWTH IS NOT LIKELY TO TAKE PLACE BEFORE NEXT SUMMER.

12. IN THE LONGER-RUN, ITS MAIN COMPETITORS, TAIWAN AND KOREA WILL CONTINUE TO ENCROACH ON ITS MARKET ESPECIALLY IN THE UNITED STATES. ALTHOUGH IT HAS EXPERIENCED A FAR SMALLER RATE OF DOMESTIC PRICE INCREASE THAN EITHER OF THESE COUNTRIES, A

COMPARISON OF EXPORT PRICES WITH TAIWAN AND KOREA FOR THE 12 MONTHS ENDING IN THE SECOND QUARTER OF 1974 INDICATES A SIMILAR RATE OF PRICE INCREASE. IN OTHER WORDS, HONG KONG'S COMPETITIVE POSITION HAS NOT DETERIORATED IN THE PAST YEAR BUT NEITHER HAS IT BEEN ABLE TO REDUCE THE GAP WITH ITS RIVALS. THE BEST ILLUSTRATION OF THIS SITUATION IS A COMPARISON OF EXPORT INCREASE, IN CONSTANT PRICE TERMS:

(IN PERCENT)

	1973	JAN. -JUNE 1974
HONG KONG	7	4
TAIWAN	21	14
KOREA	64	26

MOREOVER HONG KONG'S EXPORT INCREASE IN A WORLD MARKET, MADE ESPECIALLY BOUYANT BY INFLATION, WAS NOT EQUAL TO THE GENERAL INCREASE IN THE VOLUME OF WORLD TRADE EITHER IN 1972 (4.5 PERCENT COMPARED TO 9 PERCENT) OR IN 1973 (7.2 PERCENT COMPARED WITH 12.5 PERCENT), A POOR PERFORMANCE BY ITS HISTORIC STANDARDS.

13. THERE HAS BEEN A POLICY FAILURE. THE GOVERNMENT HAS ALLOWED THE EXCHANGE RATES OF ITS MAJOR CUSTOMERS (THE U.S. AND U.K.) AND SOME OF ITS RIVALS (KOREA AND TAIWAN) TO DECPRECIATE VIS-A-VIS ITS CURRENCY. AT THE TIME, IT FEARED THAT CHINA WOULD RAISE ITS FOOD PRICES IN RETALIATION. THE PRC, IN FACT, DID THIS ANYWAY AS PART OF ITS EXPORT DRIVE IN 1973. WHILE THE FEELING WAS GENIUNE, THE BASIC POINT IS THAT HKG TAKES PRIDE IN INACTION. IT RATIONALIZES THIS ATTITUDE BY TAKING A COMPLACENT VIEW OF HONG KONG'S RESILIENCE.

14. THE GOVERNMENT DISDAINS THE POLICY, PIONEERED BY JAPAN, OF
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DECIDING WHERE LONG RANGE MARKET GROWTH IS GOING TO TAKE PLACE AND THEN ENCOURAGING IN VARIOUS MATERIAL WAYS, ITS ENTREPRENEURS OR ITS STATE ENTERPRISES TO INVEST TO MEET THAT DEMAND. WHILE THE BUSINESS COMMUNITY EXCELS IN ITS ABILITY TO ADAPT ITS PRODUCTS TO MARKET CHANGES IN INDUSTRIESNQN WHUSH IT IS ALREADY FAMILIAR, IT COLLECTIVELY DOES NOT HAVE THAT LONGER VISION POSSESSED BY ITS ITS NEIGHBORS TO THE NORTH OR SINGAPORE. THIS POLICY PROBABLY DOES NOT BOTHER THE INFLUENTIAL COSMOLPOLITAN TRADING HONGS AND THE FINANCIAL COMMUNITY WHICH HAVE MANY INTERESTS OUTSIDE THE COLONY. BUT,IT IRRITATES THE CHINESE MANUFACTURING GROUP WHO HAVE ALREADY CALLED FOR A PLANNING COMMISSION. THE PRICE TO BE PAID FOR A PERSISTENCE IN THIS POLICY WILL BE A SLOWER RATE OF GROWTH.
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